

Message Text

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C O N F I D E N T I A L SECTION 01 OF 03 BONN 02946

LIMDIS GREENBACK

E.O. 11652: GDS

TAGS: EFIN, GW

SUBJECT: GERMAN MONETARY POLICY AND BUNDESBANK
VIEWS ON FISCAL POLICY

1. SUMMARY. NO SIGNIFICANT CHANGES IN GERMAN MONETARY POLICY ARE EXPECTED FOR THE TIME BEING. BUNDESBANK POLICY OFFICIALS ARE CONFIDENT OF AN ADEQUATE GROWTH OF THE ECONOMY AND OPPOSED TO A FURTHER EXPANSION OF PUBLIC DEFICITS. TOP PRIVATE BANKERS HAVE GAINED THE IMPRESSION FROM CHANCELLOR SCHMIDT THAT WHILE HE IS CONCERNED OVER "TENSION" WITH THE US REGARDING GERMAN ECONOMIC POLICY, HE, TOO, OPPOSES ANY SIGNIFICANT INCREASES IN THE DEFICITS OF PUBLIC BUDGETS. THE CHANCELLOR DOES, HOWEVER, REPORTEDLY FAVOR A FURTHER REDUCTION OF LONG-TERM INTEREST RATES AND WOULD LIKE TO NUDGE THE CENTRAL BANK IN THAT DIRECTION. END SUMMARY.
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2. ALL BOARD MEMBERS WITH WHOM THE FINANCIAL ATTACHE TALKED DURING A VISIT TO THE BUNDESBANK THIS WEEK INDICATED THAT GERMAN MONETARY POLICY IS LIKELY TO CONTINUE AN ESSENTIALLY NEUTRAL STANCE FOR THE TIME BEING. (SOME FURTHER TECHNICAL INNOVATIONS ARE, HOWEVER, POSSIBLE SUCH AS THE

RECENT CHANGE IN THE DIFFERENTIAL RESERVE REQUIREMENT FOR BANKS IN DIFFERENT LOCATIONS.) UNLIKE DURING THE LAST MONTHS OF 1976, THERE NOW APPARENTLY IS LITTLE CONFLICT OF VIEW ON THE PROPER STANCE OF MONETARY POLICY WITHIN THE CENTRAL BANK COUNCIL. TOWARD THE END OF 1976 AN INFLUENTIAL GROUP FAVORED MORE RESTRICTIONIST STEPS TO BRING THE MONETARY AGGREGATES SOMEWHAT CLOSER IN LINE WITH THE ANNOUNCED GROWTH TARGET. OTHERS WERE OPPOSED BECAUSE THEY FEARED THAT SUCH STEPS MIGHT STIFLE THE STILL FRAGILE ECONOMIC UPSWING (SEE BONN 19458). THE RESULTING COMPROMISES AVOIDED ANY VERY LARGE OR HIGHLY VISIBLE RESTRICTIVE STEPS SUCH AS INCREASES IN MINIMUM RESERVES OR DISCOUNT RATES IN FAVOR OF A NUMBER OF SMALL, LESS SPECTACULAR MEASURES SUCH AS OPEN MARKET SALES OF DM 770 MILLION BY THE CENTRAL BANK IN DECEMBER AND AGREEMENT BY THE FINANCE MINISTRY TO LARGELY MEET ITS YEAR-END CASH REQUIREMENTS BY COMMERCIAL BORROWING RATHER THAN THROUGH DRAWINGS ON ITS CREDIT LINE AT THE BUNDESBANK. (THE FINANCE MINISTRY DREW ONLY DM 1.7 BILLION OF ITS DM 6 BILLION CREDIT LINE.) NOW BOTH SIDES ARE MORE RELAXED. LOAN DEMAND CONTINUES SLUGGISH SO THAT THE EXPANSION OF SOME MONETARY AGGREGATES, INCLUDING PROBABLY CENTRAL BANK MONEY, IS EVEN NEGATIVE SO FAR THIS YEAR. CONCERN WITHIN THE CENTRAL BANK COUNCIL REGARDING THE FRAGILITY OF THE ECONOMIC UPSWING, ON THE OTHER HAND, HAS ALSO CLEARLY LESSENERED WITH THE GOOD DECEMBER ORDER FIGURES (INCLUDING IN

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PARTICULAR DOMESTIC ORDERS FOR INVESTMENT GOODS) AND THE RECOVERY OF REAL GNP GROWTH TO A 6 PERCENT SEASONALLY ADJUSTED ANNUAL RATE DURING THE FOURTH QUARTER OF 1976.

3. ALL BUNDESBANK BOARD MEMBERS TO WHOM THE FINANCIAL ATTACHE TALKED ARE NOW MUCH MORE FIRMLY CONVINCED THAN THEY WERE THREE MONTHS AGO REGARDING THE STRENGTH OF THE ECONOMIC UPSWING -- WITH VERY LARGE AGREEMENT THAT AT LEAST 4.5 PERCENT OF REAL GNP GROWTH SEEMS ASSURED AND 5.0 PERCENT VERY POSSIBLE. IN THIS SITUATION NO ONE AT THE BUNDESBANK FAVORS MUCH ADDITIONAL STIMULATION. IN THEIR VIEW, MONETARY POLICY AND THE 1977 MONETARY GROWTH TARGET ALREADY ARE FULLY ACCOMMODATING OF WHAT REAL GNP GROWTH IS LIKELY. IN THE VIEW OF MOST BOARD MEMBERS A HIGHER RATE OF REAL GNP GROWTH FOR THE YEAR COULD ONLY BE ACHIEVED BY REACHING GROWTH RATES BY THE LAST QUARTER WHICH WOULD MAKE IT NECESSARY TO STEP ON

THE MONETARY BRAKES AGAIN EARLY IN 1978. ACTUALLY

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TO THE BUNDESBANK'S CHIEF ECONOMIST, SCHLESINGER,
GERMAN CAPACITY UTILIZATION BY THE END OF THIS YEAR -
AT 5 PERCENT REAL GNP GROWTH - WILL COME WITHIN
1-2 PERCENT OF THE PAST AVERAGE UTILIZATION WHICH
HE EQUATES WITH THE DESIRABLE UTILIZATION RATE. HE
FEELS THAT A HIGHER GROWTH PATH IN 1977 WOULD PREVENT
A "SOFT LANDING" IN 1978. (COMMENT: THIS IS BASED
ON INTERNAL, UNPUBLISHED BUNDESBANK CAPACITY
UTILIZATION CALCULATIONS FOR THE ECONOMY AS A WHOLE.
THE CALCULATIONS BY GERMAN ECONOMIC RESEARCH INSTITUTES
SEEM TO US TO INDICATE SOMEWHAT MORE ROOM FOR
EXPANSION. THE MOST NEARLY CURRENT INDUSTRIAL
CAPACITY UTILIZATION FIGURES PUBLICLY AVAILABLE
ARE THOSE OF THE IFO ECONOMIC RESEARCH INSTITUTE.
THE IFO INDEX STOOD AT 82.6 PERCENT IN OCTOBER 1976
AS COMPARED TO AN 87 PERCENT PAST AVERAGE UTILIZATION
AND AN ALL-TIME HIGH OF 91 PERCENT IN 1971. ASSUMING
THAT "OPTIMUM" UTILIZATION IN THIS INDEX LIES
SOMEWHERE BETWEEN THE AVERAGE AND ALL-TIME HIGH
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FIGURES AND THAT, AS THE BUNDESBANK ASSUMES, PRODUCTIVITY INCREASES BY ABOUT 2-3 PERCENT DURING 1977, THIS WOULD AT THE END OF THIS YEAR STILL LEAVE ABOUT TWICE THE 1-2 PERCENTAGE POINT MARGIN THE BUNDESBANK CALCULATES.)

4. EVEN APART FROM WHAT REAL GNP GROWTH IN 1977 MIGHT THEORETICALLY BE DESIRABLE, MOST EVERYONE AT THE BUNDESBANK ALSO ARGUED THAT THERE WAS NOT VERY MUCH MORE THAT EITHER COULD OR SHOULD BE DONE TO ACHIEVE A HIGHER ECONOMIC GROWTH RATE. MONETARY POLICY ALREADY IS CONSIDERED TO BE VERY ACCOMMODATING WITH THE BANKS IN A POSITION TO MEET MUCH LARGER LOAN DEMANDS THAN ARE ACTUALLY MATERIALIZING. AS ONE ILLUSTRATION EVERYONE CITED THE RECENT TENDER FOR FEDERAL NOTES (6.26 PERCENT INTEREST FOR THREE-YEAR PAPER AND 6.51 PERCENT FOR FOUR-YEAR PAPER) WHICH ELICITED A COMPLETELY UNEXPECTED DM 5.5 BILLION OF OFFERS FOR PURCHASES OF WHICH ONLY DM 2.0 BILLION WERE ACCEPTED. THE EAGERNESS OF GERMAN BANK PARTICIPATION IN CREDITS TO THE UK AND SWEDEN ARE OTHER EXAMPLES. (COMMENT: NO ONE AT THE BUNDESBANK EXPECTED OR ADVOCATED, HOWEVER, VERY SIGNIFICANT FURTHER DROPS IN GERMAN LONG-TERM INTEREST RATES DURING 1977.)

5. ALL BUNDESBANK OFFICIALS TO WHOM THE FINANCIAL ATTACHE TALKED WERE STRONGLY OPPOSED TO ANY FURTHER STIMULATIVE FISCAL MEASURES. FIRST OF ALL, THEY ARGUED THAT FURTHER STIMULATION WAS NOT NEEDED (SEE PARA 2). BUT IN FACT THEY SEEMED AT LEAST AS STRONGLY MOTIVATED BY THE FEELING THAT GOVERNMENT BUDGETS "WERE OUT OF CONTROL" (THE FEDERAL INDEBTEDNESS ALMOST DOUBLED IN THE LAST TWO YEARS) AND THAT DEFICIT SPENDING HAD TO BE CUT BACK OVER THE MEDIUM TERM FOR STRUCTURAL REASONS. DR. SCHLESINGER SAID

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THAT HE EXPECTS THAT WITH 9 PERCENT NOMINAL GNP GROWTH AND A 7 PERCENT INCREASE IN WAGE RATES FOR PUBLIC OFFICIALS, THE DEFICIT OF THE FEDERAL, STATE AND LOCAL GOVERNMENTS AND THAT OF THE SOCIAL INSURANCE SYSTEM WILL TOTAL ABOUT DM 56 BILLION IN 1977, DOWN ONLY ABOUT DM 1-2 BILLION FROM 1976 (SEE ALSO BONN 1935, NOTAL). THIS VERY SMALL RATE OF REDUCTION, ACCORDING TO SCHLESINGER, IS NOT ADEQUATE IF THE FEDERAL REPUBLIC IS TO COME ANYWHERE NEAR TO THE "CONJUNCTURALLY APPROPRIATE" PUBLIC BUDGETS AT

FULL EMPLOYMENT (WHICH THE ECONOMIC EXPERTS CALCULATED SOME YEARS BACK AS A DEFICIT OF DM 20 BILLION). FINALLY BUNDESBANK OFFICIALS ARGUED THAT INCREASES IN GOVERNMENT EXPENDITURES - AND PARTICULARLY INVESTMENT EXPENDITURES - IN PRACTICE COULD NOT BE UNDERTAKEN IN TIME TO BE CYCLICALLY USEFUL. IF PLANNED NOW, THEY MOST LIKELY WOULD ACTUALLY HAVE AN ECONOMIC EFFECT ONLY WHEN THIS WOULD BE PRO-CYCLICAL RATHER THAN HELPFUL. BUNDESBANK OFFICIALS BRUSHED ASIDE QUESTIONS REGARDING THE DESIRABILITY OF A TAX CUT BY ARGUING THAT IN THE CYCLICALLY IMPORTANT SHORT-RUN GERMAN TAXPAYERS TEND TO SAVE RATHER THAN SPEND THE PROCEEDS AND, IN ANY CASE, A TAX CUT WAS POLITICALLY OUT OF THE QUESTION.

6. PRIVATE BANKERS TO WHOM THE FINANCIAL ATTACHE TALKED HAD A MUCH LESS OPTIMISTIC VIEW OF THE ECONOMIC SITUATION AND PROSPECTS. THEY GENERALLY SAW THE ECONOMY CONTINUING TO OPERATE NEAR PRESENT LEVELS FOR

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LIMDIS GREENBACK

MOST OF THIS YEAR WITH ONLY MARGINAL ADDITIONAL GROWTH. ON POLICY PRESCRIPTIONS THEY WERE, HOWEVER, IF ANYTHING EVEN MORE OPPOSED TO ANY FURTHER FISCAL

STIMULATION. THE FINANCIAL ATTACHE WAS TOLD SECOND (OR THIRD) HAND THAT AT A RECENT MEETING WITH GERMANY'S TOP BANKERS, CHANCELLOR SCHMIDT EXPRESSED CONCERN REGARDING "TENSION" WITH THE US REGARDING ECONOMIC POLICY, BUT ALSO INDICATED HIS OWN FEELING AGAINST A FURTHER FISCAL STIMULUS AT THIS TIME - BEYOND THE PLANNED DM 10-12 BILLION THREE-FOUR YEAR PUBLIC INVESTMENT PROGRAM. THE CHANCELLOR IMPLIED, HOWEVER, THAT HE FELT A FURTHER DROP IN LONG-TERM INTEREST RATES WOULD BE DESIRABLE AND THAT HE WAS SEEKING WAYS TO NUDGE THE BUNDESBANK AND THE CAPITAL MARKETS IN THAT DIRECTION.

7. CONCERNING INTERNATIONAL ECONOMIC DEVELOPMENTS, EMMINGER, SCHLESINGER AND GLESKE ALL STRESSED THAT RECENT BUNDESBANK SURVEYS OF DEVELOPMENTS OF CONFIDENTIAL

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ECONOMIC GROWTH - AND PARTICULARLY INDUSTRIAL PRODUCTION - AROUND THE WORLD STRENGTHENED THEM IN THEIR MORE OPTIMISTIC ASSUMPTIONS THAN THOSE OF THE OECD SECRETARIAT REGARDING WORLD TRADE AND GERMAN EXPORTS. GERMAN IMPORTS, HOWEVER, WERE EXPECTED TO CONTINUE TO RISE AT A FASTER RATE THAN EXPORTS AND THE BUNDESBANK EXPECTS A SLIGHT REDUCTION IN THE GERMAN CURRENT ACCOUNT SURPLUS IN 1977. (THE EMBASSY EXPECTS A SLIGHT INCREASE--SEE BONN 20918.)

8. EMMINGER AND GLESKE STUCK TO THE PAST BUNDESBANK VIEW THAT ONE SHOULD GO SLOW IN THE CREATION OF ANY NEW INTERNATIONAL LIQUIDITY OR BALANCE OF PAYMENTS FINANCING. THEY FELT THAT THE MULTINATIONAL BANKS WERE NOW ENGAGED IN A CONCERTED DRIVE TO REDUCE THE RISKS OF THEIR ENGAGEMENTS BY PRESSING FOR MORE OFFICIAL LENDING. IN FACT, HOWEVER, AS THE RECENT DM 1.5 BILLION COMMERCIAL LOAN TO THE UK HAD SHOWN, MORE OFFICIAL LENDING WOULD NOT SUBSTITUTE FOR PRIVATE LENDING, BUT RATHER WOULD ENCOURAGE ADDITIONAL PRIVATE LENDING. IN THE END, THEY IMPLIED, THE DANGER CONTINUED TO BE THAT THERE WOULD BE TOO MUCH, RATHER THAN TOO LITTLE, FINANCING AND NOT ENOUGH ADJUSTMENT.
STOESSEL

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